

# **BUSINESS TAXES AND LICENSING**

## **Internal Controls Review**

**May 18, 2005**

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City of Seattle  
Office of City Auditor

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Susan Cohen, City Auditor

May 18, 2005

The Honorable Greg Nickels  
Seattle City Councilmembers  
City of Seattle  
Seattle, Washington 98104

Dear Mayor Nickels and City Councilmembers:

Attached is our report on *Business Taxes and Licensing*. The primary objectives of the review were to determine whether internal controls surrounding the City's business taxes and licensing functions and policies were adequate. We especially focused our efforts on reviewing controls that could have a financial impact on the City.

We appreciate the excellent cooperation and collaborative efforts of the Department of Executive Administration management and staff during the review process. The Department of Executive Administration response to our review is included under the 'Actions Planned' section for each issue in the report.

Sincerely,

Susan Cohen  
City Auditor

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Attachment

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## CHAPTER 1: INTRODUCTION AND BACKGROUND

The City of Seattle requires businesses operating in the City or having nexus<sup>1</sup> with the City to obtain a City business license and file City business taxes. The City requires businesses to pay a variety of taxes, depending on the nature of the business activities in which they are engaged. These include the Business & Occupation (B&O) tax, utility tax, admission tax, and gambling tax, as applicable. Sections 5.32 through 5.55 of the Seattle Municipal Code, and Chapter 82 of the Revised Code of Washington (RCW), provide the primary legal authorities and guidelines for City business licenses and taxes. In 2003, the City received approximately \$250 million in business taxes and license fees, which accounted for about 27 percent of the City's total annual revenues.

The City's business tax and licensing functions are dispersed to a number of departments throughout the City.<sup>2</sup> The Revenue and Consumer Affairs Division within the Department of Executive Administration has the primary responsibility for enforcing the City's business tax and licensing requirements. This responsibility includes tax and license processing, enforcement and inspection efforts, and tax auditing.

Our review focused on evaluating the City's overall internal controls<sup>3</sup> governing business tax and licensing policies, procedures, and operations.

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## RESULTS IN BRIEF

Overall, we found internal controls were adequate for the City's business licensing and taxation policies, procedures, and operations. However, the City could recover several million dollars more in tax and license revenues by adding resources to the Tax Audit and Enforcement areas. We also found that controls related to the handling of payments require improvements in several areas. Further, we identified potential improvements in other areas, including the effectiveness of tax audit practices, the efficiency of tax return processing, review of exception transactions, legal action practices, and the timeliness of tax refunds.

The City's current tax audit resources are insufficient to provide a level of audit coverage that maximizes tax revenue recoveries. Current resources allow for four-year cyclical audits of the City's largest business taxpayers who contribute about 20 to 25 percent of the total business tax

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<sup>1</sup> When a business has nexus with a locality, it means it performs activities in the locality that are significantly associated with the taxpayer's ability to establish and maintain a market in the locality. Nexus could be established by an office or warehouse/delivery facility in the locality, a sales representative based in the locality or one who makes regular visits to the locality, a project underway such as a construction project or large consulting project in the City, etc. If a business has nexus with the City, it is required to pay taxes on the value of its in-city business, measured by its gross income.

<sup>2</sup> See Appendix 1 for City departments' and the one outside agency's associated responsibilities and functions as related to business tax and licensing responsibilities for the City.

<sup>3</sup> Internal controls are the practices and procedures of an organization that are designed to help ensure that a business achieves its objectives. Specifically, they help ensure: 1) protection of assets; 2) compliance with laws, policies, and procedures; 3) integrity of management information (i.e., information is accurate, complete, timely, and usable); 4) effectiveness of operations; and 5) efficiency of operations.

revenues. In comparison, the State of Washington plans their tax audit coverage based on the businesses that represent about 80 percent of the State's total tax revenues. In addition, there are opportunities to expand audit coverage of utility taxes, admission tax, and certain event vendors. Although the City is directing its available audit resources to the most value-added audit activities, adding tax audit resources would provide a greater net benefit to the City. (See tax audit revenue recovery history data in **Appendix 2.**) We also found that the lack of a travel budget for tax audit work is hampering audit effectiveness.

The City's current level of enforcement resources does not allow for maximum recoveries of business tax and license revenues. The Revenue and Consumer Affairs Enforcement group is responsible for enforcing compliance with the City's tax and licensing code. Their activities include identifying businesses operating without a license, and following up with businesses that have not filed taxes or have not fully paid the amounts due. The City's current level of enforcement resources does not allow for thorough and consistent follow-up with all non-compliant businesses. While the City is directing its enforcement resources to the most value-added activities, increasing enforcement resources would provide a greater net benefit to the City. (See enforcement revenue recovery history data in **Appendix 2.**)

Overall, we found there were proper internal controls in place for the handling of tax and license payments that are mailed or brought in by the customer and processed by the Treasury group, which covers the majority of payments. However, we found several payment handling practices that need improvement. Currently, separation of duties controls<sup>4</sup> are not adequate because Assistant Auditors directly receive payments for tax investigations they initiate. Management identified a similar control weakness with the handling of replacement checks for non-sufficient funds (NSF) tax and license payments, which led to a theft of \$300. A separation-of-duties issue also exists with tax and license payments that are sent directly to Inspectors as a result of their enforcement follow-up work. In addition, checks could be better protected during the mail sorting process by limiting key access to authorized personnel.

There are large backlogs in tax return processing, specifically tax detailing, due to insufficient resources in the Revenue and Consumer Affairs Operations group and the manual nature of the tax detailing process. However, tax payments are processed and deposited in a timely manner. Management review is not adequate for exception type transactions, such as adjustments to obligations, or account closures with open obligations. Guidelines should be established and followed for determining when Revenue and Consumer Affairs should pursue filing criminal complaints or pursue other legal actions against non-compliant businesses. Tax refunds also need to be issued more timely.

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## **BACKGROUND**

The City of Seattle requires businesses operating in the City or having nexus with the City to obtain a City business license and file City business taxes. Businesses are required to maintain a valid City business license and renew it annually. The City requires businesses to pay a variety of taxes, depending on the nature of the activities they are engaged in. These include Business

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<sup>4</sup> Employees should not have complete control over a transaction from initialization to completion in order to maintain proper separation of duties.

and Occupation (B&O) tax, utility tax, admission tax, and gambling tax. The B&O tax rate ranges from .215 percent to .415 percent of gross income, the utility tax rate ranges from 6 percent to 10 percent of gross income earned from utility type business activities, the admission tax rate is 5 percent of admissions income, and the gambling tax rate is 2 percent to 10 percent of gross income earned from specific gambling activities. There are various exemptions, deductions, and credits allowed. Sections 5.32 through 5.55 of the Seattle Municipal Code, and Chapter 82 of the Revised Code of Washington (RCW), provide the primary legal authorities and guidelines for City business licenses and taxes.

In 2003, the City received approximately \$128 million in B&O tax, \$118 million in utility tax, \$7 million in admission tax, and about \$1 million in gambling tax (2002 data). The City also receives about \$4 million dollars annually for business license fees. Taken altogether, these proceeds represent about 27 percent of the City's total annual revenues.

The Mayor and City Council establish the City's business licensing and taxation policies, with input provided by the Director of Revenue and Consumer Affairs and the Finance Department Director. It should be noted that the City's ability to change or enforce the Municipal Code is strongly controlled by State legislation. In addition, the City of Seattle has adopted the Model Tax Ordinance, which is an effort by 39 Washington cities and the State of Washington to establish consistent State and municipal business & occupation taxation practices. The Ordinance can only be amended every four years and all participating cities must agree to the amendment.

Several City departments and divisions are responsible for the City's business licensing and taxation efforts (**Appendix 1**). The Revenue and Consumer Affairs Division is primarily responsible for executing and enforcing City business tax and license policies. The Treasury Division within the Department of Executive Administration handles the processing and posting of license and tax payments. The Seattle Municipal Court handles business enforcement cases and the Office of Hearing Examiner hears tax appeal cases. The City Attorney's Office represents the City in business tax and license cases involving civil and/or criminal matters.

There are three groups within Revenue and Consumer Affairs primarily dedicated to executing and enforcing the City's license and tax policies: Enforcement, Tax Audit, and Operations.

- The Enforcement group is primarily responsible for ensuring that businesses operating in the City obtain the proper licenses. This group also follows up with businesses that are delinquent in license renewals or payment of taxes, fees, and penalties.
- The Tax Audit group audits businesses to determine whether they have reported City taxes accurately, or if they owe the City additional taxes. This group also audits businesses within the City that the Enforcement group has discovered operating without a license, to determine how much the businesses owe for back-taxes.
- The Operations group handles customer service, processing of license applications, tax return paperwork, and maintains customer accounts on the Seattle Licensing Information Management (SLIM) system database.

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## SCOPE AND METHODOLOGY

We initiated this review of the City's overall internal controls governing business tax and licensing policies, procedures, and operations in January 2004. We selected this area for review because of the magnitude of the revenue stream generated by business taxes and license fees for the City and the associated high financial risks in protecting these assets. In 2003, revenues from business tax and licensing fees totaled approximately \$250 million, or 27 percent of the City's total 2003 revenues.

During this review, we focused on internal controls with an emphasis on those with a financial impact. Specifically, we reviewed internal controls relating to the areas listed below:

- Tax and licensing codes and policies
- Communication of licensing and tax requirements
- Business license application and renewal processes
- Code enforcement activities
- Specialty area code enforcement activities (i.e., tradeshow, admissions, gambling, utilities, construction)
- Tax return and tax collection processes
- Tax auditing
- Accounting for tax and license revenues and receivables
- Information systems

It should be noted this review only covered "revenue type" business licenses. It did not cover regulatory licenses (except for tradeshow licenses), animal licenses, or any other type of City license.

We based our audit conclusions from interviews with City personnel, review and analyses of regulatory requirements, review and analyses of procedures and policies and available documentation and electronic data. We also observed the operations of the City's Revenue and Consumer Affairs Division, and compared them to the procedures used by the State of Washington's Department of Revenue.

We conducted the fieldwork for this review between January and November 2004. We used sampling techniques based on a risk-based approach which allow for a cost-effective way to review significant controls. Our review, therefore, would not necessarily disclose all significant weaknesses and irregularities. In performing audits, our office follows the Government Audit Standards, as prescribed by the Comptroller General of the United States, and the Institute of Internal Auditors' (IIA) International Standards for the Professional Practice of Internal Auditing. With respect to quality assurance reviews and training, the Seattle Office of City Auditor follows the IIA standards.



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## **CHAPTER 2: BUSINESS TAXES AND LICENSING INTERNAL CONTROLS REVIEW**

The Office of City Auditor conducted this review to assess the condition of internal controls for the City's business licensing and taxation policies, procedures, and operations. Overall, we found internal controls to be adequate. However, we found several areas requiring improvement. Most notably, the City could increase tax and license revenue recoveries by several million dollars if resources were added to the Revenue and Consumer Affairs Tax Audit and Enforcement groups. We also found that payment-handling controls require improvement in several areas. There were several other findings, including those addressing the effectiveness of tax audit practices, the efficiency of tax return processing, management review of exception transactions, legal action practices, and the timeliness of tax refunds.

### **TAX AUDIT FUNCTION**

Seattle Municipal Code sections 5.40, 5.45, 5.48, and 5.52 cover the taxation requirements for businesses generating income within the City of Seattle. Section 5.55.060A establishes the City's authority to conduct tax audits. The Tax Audit group resides within the Revenue and Consumer Affairs Division of the Department of Executive Administration. This group audits businesses to determine whether they have reported City taxes accurately. They also audit businesses discovered operating without a license to determine how much the business owes the City for back taxes. Audits generally consist of comparing the books and records of a business to what was reported on City tax returns. Tax audits may involve on-site visits (including to out-of-state business locations), or they may be accomplished through phone, mail, and electronic communications. The Tax Audit group also conducts investigations, which rely on taxpayer verbal representation to determine whether all taxes owed have been paid. The Tax Audit group is comprised of a total of eight Auditors and Assistant Auditors and one supervisor.

Overall, we found internal controls of the City's tax auditing functions to be adequate. However, we noted several areas where controls need improvement. On the positive side, given the present level of available audit resources, the City is appropriately selecting businesses for audits based on risk. We found that the City is conducting tax audits properly, adequately documenting their work, and that the audit work supports the audit conclusions and tax assessments. We found that the City is properly handling tax assessment payments and following up on amounts due. The City is handling tax appeal cases so as to maximize the City's success rates. On the opportunities side, the most important improvement needed is an expansion of audit resources and audit coverage, including B&O tax audits, utilities tax audits, admission tax audits, and audits of event vendors. In addition, the establishment of a travel budget for tax audits would improve audit effectiveness. Tax investigation payment separation of duties controls need to be improved, and the City's tax rules need to be updated.

**Conclusion 1: The City Is Not Maximizing Recovery Of Business Tax Revenues Due To Insufficient Resources In The Tax Audit Group And An Inadequate Level Of Tax Audit Coverage.**

***Subfinding 1: The City's current level of resources for the Tax Audit group is insufficient to maximize recovery of tax-related revenues.***

**Background**

The vast majority of the City's business tax audits result in a tax assessment to the audited businesses. Audit results indicate businesses often under-report gross income, incorrectly classify gross income by business activity (e.g., retail versus service, non-utility versus utility), incorrectly apportion income outside the City of Seattle, and inappropriately claim deductions or credits. In 2003, the Tax Audit group was responsible for recovering about \$16 million in "lost revenues" through their audit and investigatory efforts. According to Revenue and Consumer Affairs management, the amount recovered in 2003 was unusually high due to several large assessments. Normally the annual recovery amount ranges between \$5 million to \$6 million. (See Exhibit 1 for 1999-2004 revenue recovery data.) Revenue and Consumer Affairs management indicated that each auditor normally recovers about \$500,000 to \$750,000 annually, although this number was substantially higher in 2003. It should be noted that each auditor is recovering amounts far in excess of their cost to the City in salary and benefits, which are about \$75,000 to \$80,000 annually.

**Exhibit 1: Tax Audit Revenue Recoveries <sup>5</sup>**

<b>Years</b>	<b>Tax Audit Recoveries</b>
<b>1999</b>	\$ 4,988,583
<b>2000</b>	\$ 6,101,617
<b>2001</b>	\$ 5,398,928
<b>2002</b>	\$ 6,756,423
<b>2003</b>	\$ 16,343,692
<b>2004</b>	\$ 7,496,836

The City selects businesses for business tax audits based on several criteria. The size of the business is a leading factor. The largest businesses are generally audited every four years, which is the statute of limitations for a business operating with a valid business license. Currently, the City tries to audit the "top 100" businesses with the highest gross income on a four-year cyclical basis. These 100 businesses account for approximately \$25 million (or 20 percent) of the City's annual B&O tax revenues of about \$128 million. The City also audits businesses based on referrals, and potential exceptions and "red flags" that are identified during Revenue and Consumers Affairs' tax return reviews. Businesses within the City that are discovered operating without a license are often audited to determine whether they owe the City for back taxes. The statute of limitations is 10 years for a business operating without a valid business license.

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<sup>5</sup> Data provided by the Director of Revenue and Consumer Affairs.

### Issue, Impact, and Recommendation

The Seattle Municipal Code defines the payment requirements for businesses operating within the City for the various City business taxes (B&O, utility, admission, gambling). The City should maximize the collection efforts for taxes owed, including the recovery of “lost revenues” through tax audit and enforcement efforts. Audit results and account delinquency reporting clearly indicate that businesses often under-report taxes, do not report taxes at all, and/or inappropriately take credits and deductions; consequently, the City needs to conduct tax audits in order to recover this potential revenue. Currently, the City is not maximizing tax revenue recovery due to insufficient tax audit resources. However, the Tax Audit group is doing a commendable job in focusing the resources they have on the most cost-beneficial audit activities.

Historically, the City has had sufficient tax audit resources to ensure a regular four-year audit cycle for businesses that account for 20 to 25 percent of the City’s annual B&O tax revenues, and to audit other accounts that are: 1) referred, 2) exhibit substantial recovery potential, or 3) discovered to be operating without a business license. In comparison, the State of Washington Department of Revenue plans their tax audit coverage based on the businesses that represent about 80 percent of the State’s total tax revenues (sales tax and B&O tax). To accomplish this goal, the State performs tax audits on 10 percent of their business accounts every four years. It should be noted that the State’s audit staffing is sufficient to accomplish this level of audit coverage. As with the City, State tax audits indicate the vast majority of audited businesses owe additional taxes.<sup>6</sup>

The City’s top 1,000 businesses account for about 70 percent (or \$88 million) in annual B&O tax revenues. To achieve a level of audit coverage somewhat comparable to the State’s, the City would need to perform 250 or more field audits annually. The City does not have enough tax auditors to provide this level of audit coverage. Currently, the Tax Audit group performs about 100 to 150 on-site audits (field audits) per year.

Insufficient audit resources hampers the City’s ability to recover lost tax revenues and negatively affects the City’s “bottom line.” Many businesses that are non-compliant with City tax regulations and should owe additional taxes are not audited due to insufficient City audit resources. Each Tax Auditor and Assistant Auditor annually recovers revenues in excess of \$500,000, well below their annual cost to the City in salary and benefits, which is about \$75,000 to \$80,000.

We recommend the City hire additional tax auditors to minimize lost tax revenues due to business non-compliance with City tax regulations. An increase in audit staff might also require an increase in legal and other support staff. We reported this issue to the Department of Executive Administration in an October, 2004 interim audit report. At that time, the City provided the Department of Executive Administration with additional budget to fund an additional half-time tax auditor. Additional resources however, are warranted to ensure the City maximizes tax revenue recoveries.

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<sup>6</sup> Our audit scope did not include verifying whether the Washington State Department of Revenue achieved its tax audit coverage goals.

## **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs will conduct a cost-benefit analysis to determine the potential benefit to the City from hiring additional tax auditors. This analysis will take into consideration costs associated with additional support staff needs (i.e., legal, operations, etc.), if applicable. This analysis should be completed by September 30, 2005 and actions will be based on a discussion of the results.

### **Subfinding 2: *The current policy for Tax Audit travel expenses is hampering the City's ability to maximize tax revenue recoveries.***

#### Background

Many businesses that are required to file City business taxes are based outside of the Puget Sound area. These businesses have nexus with the City because they generate income within Seattle and are required to pay City business taxes on this income. The City conducts tax audits on businesses that operate within the City, regardless of whether they are located in the area or outside of it. The Tax Audit group normally performs on-site visits (field audits) for larger sized businesses, versus simply reviewing the paperwork they submit. Field audits involve on-site visits to the companies to review their books and records, and interview key personnel. If out-of-area travel is necessary to conduct on-site audit work, section 5.55.060B. 2 of the Seattle Municipal Code currently requires the company being audited to pay the City in advance for the estimated travel costs.

#### Issue, Impact, and Recommendation

Tax audit practices should be established to maximize audit effectiveness. Current City policy regarding tax audit travel expenses does not support the Tax Audit group to maximize revenue recovery.

On-site visits are essential to performing an effective tax audit of a large or complex business. The auditor interviews staff, reviews the books and records, and gains a first-hand understanding of the business activities and how the company earns, tracks and accounts for its income. The auditor also can obtain an understanding of the full nature of the business activities and operations through an on-site visit. Currently, if the City believes that it needs to perform an on-site tax audit visit, they must first convince the company to pay for the travel costs. This has proven to be difficult to impossible. The City has very little recourse if the company refuses to pay audit travel costs. Often, the company will try to deal with the matter by forwarding information and data by mail and/or electronically. It is difficult for the auditor to attest to the veracity of forwarded information if it cannot be traced to its source. By comparison, the State of Washington Department of Revenue fully funds its tax audit travel expenses.

We recommend that the City fund tax audit travel for those audits where it is deemed cost-beneficial, or where the potential tax recoveries could outweigh the cost of the travel, and amend the Seattle Municipal Code accordingly.

## **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

This issue will be addressed as part of the cost-benefit analysis the Director of Revenue and Consumer Affairs is conducting (discussed at **Conclusion 1, Subfinding 1**, pg. 8). This analysis should be completed by September 30, 2005 and actions will be based on a discussion of the results.

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### **Conclusion 2: Separation Of Duties Controls Are Not Adequate For The Handling Of Payments Received As A Result Of Tax Investigation Work.**

#### **Background**

Tax returns are detailed by manually entering the information from the return into the SLIM database system. During this process, operators perform a cursory review for unusual data. Assistant Auditors then review each tax return and look for “red flags.” For example, they review the size and the type of all deductions, and check gross income reports of exactly or near \$50,000, the minimum B&O tax threshold. If the Assistant Auditor notes any item of potential concern, they send the business a letter asking for additional information. Sometimes the taxpayer simply needs a replacement tax form sent. The Tax Audit group tracks these accounts as “tax investigations” until the issues are resolved or the replacement tax return is filed.

#### **Issue, Impact, and Recommendation**

Opportunities for payment theft arise when employees have control over a transaction from initialization to completion. Proper separation-of-duties controls should be in place for the handling of all payment transactions. Employees should not have complete control over a transaction from initialization to completion. Currently, Assistant Auditors receive payment directly for the tax investigations that they initiate. The potential exists for theft of these payments because the Assistant Auditors initiate the investigation, track the investigation, receive any payments, and update the customer account. It is likely Revenue and Consumer Affairs management would not detect a theft of funds because they do not actively supervise or even have awareness of all ongoing tax investigations. We recommend a new procedure be adopted for the handling of tax investigation payments to ensure proper separation of duties.

## **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs will ensure a procedure with proper separation-of-duties controls is put in place for receipt of tax investigation payments by June 30, 2005.

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### **Conclusion 3: The Level of Audit Coverage for Utilities, Admissions, and Events Could Be Improved.**

***Subfinding 1: Utility tax audits have not been conducted for Seattle City Light, Seattle Public Utilities, and Seattle Steam.***

#### **Background**

Utility tax rates range between 6 percent and 10 percent of gross income, depending on the type of utility activities the business engages in. The City received about \$118 million in utility taxes in 2003. These taxes are remitted monthly. Section 5.48 of the Seattle Municipal Code covers utility tax requirements.

The Tax Audit group in Revenue and Consumer Affairs conducts utility tax audits to determine whether taxes have been accurately filed and remitted to the City. They have audited most of the large utility businesses within the last few years, or plan to do so soon. The planned audits include companies involved in telecommunications, data communications, waste management, and energy services.

#### **Issue, Impact, and Recommendation**

The City should perform utility tax audits on a four-year cycle for the largest taxpayers. The Tax Audit group has followed this strategy, except they have not conducted audits of Seattle City Light, Seattle Public Utilities, or Seattle Steam. These organizations pay large sums monthly and annually in utility taxes. Both of the City utilities pay utility taxes in the million dollar plus range monthly, and Seattle Steam pays between \$40,000 and \$140,000 monthly. Though Seattle City Light and Seattle Public Utilities are owned by the City of Seattle, it should be noted that utility tax revenues are recorded to the General Fund (90 percent) and Parks Fund (10 percent), and utility taxes paid by the public utilities are an expense that is ultimately borne by the utility ratepayers. According to Revenue and Consumer Affairs management, a review was conducted several years ago on Seattle City Light utility taxes, but the review was not as comprehensive as a tax audit.

Due to the size of these three utility taxpayers, we recommend that Seattle City Light, Seattle Public Utilities, and Seattle Steam be audited every four years, along with the other large utility taxpayers.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The three utility companies mentioned will be incorporated into the City's tax audit plan. One of the City utilities will be audited by December 30, 2005.

## **Subfinding 2: The City has conducted very few admission tax audits of smaller admissions-charging venues.**

### Background

The admission tax rate is 5 percent of admissions income and is remitted monthly to the City. The City received about \$7 million in admission taxes in 2003. Event sponsors must apply for a Certificate of Admission Tax before they host a show or event where there is a charge for entry either by ticket sales, cover charge, or invitation. Non-profit organizations and Seattle's two major stadiums are exempt from City admission tax. Section 5.40 of the Seattle Municipal Code covers City admission tax requirements.

The Tax Audit group conducts admission tax audits to determine whether taxes have been accurately filed and remitted to the City. They have audited the larger admission-charging businesses/entities, such as the Key Arena and large movie theatre chains within the recent past or plan to do so soon.

### Issue, Impact, and Recommendation

The City should perform admission tax audits if the potential for revenue recovery outweighs the cost to perform the audits. Currently, the City is only auditing the largest admissions-charging venues, but rarely audits smaller venues, such as bars, nightclubs, or the smaller movie theaters. This is partly due to the resource issues discussed above in **Conclusion 1**, and the City's tax audit strategy to direct audit resources towards activities with potential for the greatest return for the City. The Enforcement group has an Inspector dedicated to the Admissions area, who works to identify upcoming admissions events and ensure the event sponsor is properly licensed and has obtained an Admission Certificate. However, there is no subsequent, consistent review or reconciliation to verify that the event sponsor filed an admission tax return and that the admissions income reported appears reasonable, given the nature and size of the event(s) they hosted. Given the results of City B&O and utility tax audits, it is likely that event sponsors either under-report their revenues, or do not report at all, to evade admission tax.. If this is the case, then the current scarcity of admission tax audits hinders the City's ability to maximize tax revenue recoveries.

Admission tax audits are relatively quick and easy to perform, provided the event sponsor maintains reasonable records. If the sponsor cannot produce records, the City is authorized to estimate the admissions income and assess taxes based on that estimate. In past years, Admissions Inspectors attended events to verify attendance levels and collect the admission tax after the event, on-site. This was a particularly effective way to collect due revenues from difficult-to-contact, out-of-town event sponsors. This practice has been discontinued for events occurring at night and on weekends, when most of these events occur, because overtime pay is no longer authorized for the Inspectors.

We recommend that admission tax audits be increased on a trial basis to include smaller admission-charging venues to determine the cost-benefit of whether additional tax revenue recoveries would outweigh the additional costs. We also recommend that Enforcement reconsider the practice of having Admissions Inspectors attend some of the events, especially larger events sponsored by out-of-town organizations. Any actions should consider their

associated costs and benefits, and should not be implemented without a realistic potential net gain for the City.

### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs is working on addressing this issue in several ways. The City has a BARS Team, which is a combined (cross-departmental) enforcement team, assisting with addressing admissions tax compliance issues. Revenue and Consumer Affairs is now conducting audits of some of the smaller venues, including nightclubs, and is tracking club admissions in a new way to verify proper payment of admission tax. A new plan to address admission tax compliance should be completed and implemented by December 30, 2005.

### **Subfinding 3: Sales generated at auto, boat, and recreational vehicle (RV) shows may not be properly reported for B&O tax purposes.**

#### Background

Tradeshow organizers must apply for a Tradeshow Regulatory License and pay the associated fees before the event. If the tradeshow is scheduled for over 14 days, each participant needs a City of Seattle business license. Section 6.20 of the Seattle Municipal Code covers City requirements for tradeshow licensing. These requirements only apply to tradeshows that are open to the public, not to tradeshows where attendance is by invitation only. The Enforcement group has an Inspector dedicated to the Tradeshow area, and this Inspector works to identify upcoming tradeshows and ensure the organizer obtains the proper license and pays the correct fees. The fees are dependent on the number of participating vendors and the event length.

#### Issue, Impact, and Recommendation

The City should ensure that all businesses generating income within the City properly file and pay B&O tax. Currently vendors participating in auto and boat shows in the City rarely pay City B&O tax. These vendors generally declare \$0 in gross income related to the shows, though it seems unlikely that these events are not actually generating sales. These events feature high-ticket items taking the sales of one or a few items to meet the minimum \$50,000 annual gross income threshold for B&O tax to apply. Confirmation of inaccurate tax filings may require tax audits of these vendors. The Tax Audit group has audited some of these show vendors in the past, but due to limited tax audit resources, has not done so recently. The current situation could be hindering the City's efforts to maximize tax revenue recoveries.

As a case in point, in 1997 the Tax Audit group audited a Recreational Vehicle (RV) vendor, who was found to be operating without a license and not filing/paying City taxes. The City issued a tax assessment for over \$10,000 and now the company has a City license and regularly files and pays B&O tax for RV's sold at shows held in Seattle. Tax Auditors used to attend some of these shows "incognito," and this was the best way for the City to determine whether sales were actually made at the events. According to Revenue and Consumer Affairs management, this practice was discontinued due to limited resources and the lack of authorized overtime pay. Again, most auto, boat, and RV shows occur at nights and on weekends. Tax Audit management indicated that in the past vendors would document show sales in their records, but have discontinued this practice, making it more difficult for the City to tie actual sales to the shows. Now, vendors may show the sale as occurring at a company headquarters or



distribution location outside the City, though the actual sale and marketing effort, and customer contact point occurred at a show within the City.

We recommend that Enforcement and Tax Audit review their current practices for auto, boat, and RV shows and consider whether it would be worthwhile to return to having Tax Auditors attend some of these events, with the objective of determining whether sales are being made. Any actions taken should consider costs and benefits, and not be taken unless there will be a net gain for the City.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

This issue will be addressed as part of the cost-benefit analysis the Director of Revenue and Consumer Affairs is conducting (discussed at **Conclusion 1, Subfinding 1**, pg. 8). This analysis should be completed by September 30, 2005 and actions will be based on a discussion of the results.

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#### **Conclusion 4: The City's Tax Rules Need To Be Updated.**

##### **Background**

Pursuant to the Seattle Municipal Code, the City adopted business tax rules to assist taxpayers in filing tax returns and in determining the amount of tax due. In the event that a conflict exists between a tax rule and a City ordinance, the ordinance prevails.

##### **Issue, Impact, and Recommendation**

The City's Tax Rules should be updated to properly support Section 5 of the Seattle Municipal Code. Although the current rules were repealed December 31, 2001, they still serve as guidance for business taxpayers. Since 2002, Revenue and Consumer Affairs has been working on promulgating new rules to reflect the tax code changes specified by Ordinance 120668, which was signed by the Mayor in December 2001; however, the new rules have not yet been completed or implemented due to other priorities. The adoption of new tax rules could help the City by addressing some of the arguments and "loopholes" businesses use to win tax assessment appeals. We recommend the tax rules be updated to conform to the current tax code.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs is working on updating the business tax rules. The most significant rules will be updated by December 30, 2005.

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#### **ENFORCEMENT FUNCTION**

Chapter 6.02 of the Seattle Municipal Code covers licensing requirements for businesses generating income within the City of Seattle. The Enforcement group within the Revenue and Consumer Affairs Division of the Department of Executive Administration enforces the City's business license code. Enforcement looks for businesses operating in the City without a proper business license, and follow up with businesses that are "delinquent" in renewing their license

and/or filing and paying City business taxes. Each Inspector in the Enforcement group covers certain regional districts within the City and/or they cover a specialty area. The Enforcement group is comprised of 11 Inspectors, a manager, and two support staff.

Overall, we found internal controls to be adequate for the City's business tax and licensing enforcement functions. The City is doing a good job in identifying businesses that are not in compliance with tax and licensing requirements and helping them become compliant. We also found that the City is generally doing well in communicating tax and licensing requirements to businesses. We also noted several areas where controls could be improved. Although the City is directing their current available enforcement resources appropriately, an expansion of enforcement resources to ensure consistent and thorough follow-up for non-compliant businesses is the most critical area that can be improved. Additionally, separation-of-duties controls need to be improved for the handling of payments with an increased review of exception-type transactions. Policies and practices with respect to the following could be improved: pursuing legal actions; issuing tax refunds in a timelier manner; and communicating tax requirements to construction companies.

**Conclusion 5: The City Is Not Maximizing Recovery Of Business Tax And License Revenues Due To Insufficient Resources In The Enforcement Group.**

**Background**

The Enforcement group has two primary functions – identification of businesses operating in the City without a City business license (called discovery), and pursuing businesses that are delinquent in the filing and/or payment of taxes and license fees. Inspectors are assigned to monitor regional districts of the City and/or they specialize in a certain business type or activity, including construction, utilities, gambling, tradeshow, and admissions.

Each District Inspector is responsible for monitoring approximately 8,000 business accounts. Approximately half of these businesses are required to file taxes annually versus quarterly because of their smaller size and expected income. Inspectors monitor accounts to determine if license renewals are current, business taxes are filed/paid regularly, and if monies are owed to the City for any other fees, interest, and/or penalties. Inspectors follow up on delinquent accounts with phone calls, letters, on-site visits, or, if necessary, legal enforcement actions. In addition to monitoring accounts and pursuing delinquent accounts, Inspectors are also responsible for conducting business discovery work for their districts. Discovery is the identification of businesses operating within the City that have not obtained a City business license. When businesses are “discovered,” the Tax Audit group will often conduct an audit to determine how much is owed to the City in back-taxes. The statute of limitations for businesses operating without a valid license is ten years, so discovery can result in large tax assessments (inclusive of interest and penalties). Each Inspector generally recovers approximately \$300,000 to \$400,000 annually in taxes and license fees through their enforcement efforts. (See Exhibit 2 for the Enforcement group's 1999-2004 revenue recovery data.) It should be noted that each Inspector recovers amounts far in excess of their salary and benefits cost to the City.

## **Exhibit 2: Enforcement Revenue Recoveries <sup>7</sup>**

<b>Years</b>	<b>Enforcement Recoveries</b>
<b>1999</b>	\$ 3,087,442
<b>2000</b>	\$ 3,320,588
<b>2001</b>	\$ 3,548,364
<b>2002</b>	\$ 4,080,081
<b>2003</b>	\$ 3,086,230
<b>2004</b>	\$ 3,298,751

### Issue, Impact, and Recommendation

The Seattle Municipal Code lists the licensing and tax payment requirements for businesses operating within the City. The City should ensure the Code is thoroughly and consistently enforced, and should maximize recovery of tax and license revenues through enforcement efforts. Business account delinquencies and discovery efforts clearly indicate businesses often do not obtain or renew licenses, do not regularly file and pay taxes, or do not pay monies owed to the City for fees/interest/penalties. Consequently, enforcement activities are necessary for the City to recover these revenues. Currently, the City is not maximizing tax and license fee revenue recovery due to insufficient enforcement resources. However, the Enforcement group is doing a good job in focusing their current resources on the most cost-beneficial enforcement activities.

Currently, each Inspector handles an average of 8,000 business accounts. Our audit fieldwork indicates that approximately 450-500 of these accounts may be significantly delinquent at any given time and require follow-up<sup>8</sup>. We found that Inspectors do not have sufficient time to follow up on all of the delinquent accounts that need attention. In addition to delinquent accounts, Inspectors are responsible for conducting discovery work for their districts. We noted that the Washington State Department of Revenue has a separate group within their Compliance Division dedicated to discovery, and a group dedicated to following up delinquent accounts. On average, the State compliance officers receive 160 delinquent account referrals per month for follow up.

This resource shortage hurts the City's "bottom line" because the resulting lost tax and license fee revenues prevents the City from thoroughly and consistently enforcing the Seattle Municipal Code. It also results in delays when follow-up actions are not taken in a timely manner against non-compliant businesses. Each Inspector recovers revenue (\$300,000) well in excess of their cost to the City in salary and benefits (about \$75,000 to \$80,000). We recommend resources be added to the Enforcement group to minimize lost tax and license fee revenues due to business non-compliance. It should be noted that we reported this issue to the Department of Executive Administration in an October 2004 interim audit report.

### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs will conduct a cost-benefit analysis to determine the potential benefit to the City from hiring additional Enforcement inspectors. This analysis

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<sup>7</sup> Data provided by the Director of Revenue and Consumer Affairs.

<sup>8</sup> This figure does not include accounts showing as delinquent for a small penalty or fee.

will take into consideration costs associated with any additional support staff needs (i.e., legal, operations, etc.), if applicable. This analysis should be completed by September 30, 2005 and actions will be based on a discussion of the results.

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**Conclusion 6: Separation of Duties Controls For Payment Handling Within The Enforcement Area Need Improvement.**

**Subfinding 1: Separation of duties controls are not adequate for payments received by Enforcement.**

**Background**

Inspectors often are in the field visiting businesses to ensure they are compliant with City licensing requirements, and to follow up with businesses that are non-compliant with licensing and tax requirements. Inspectors may give or mail a Notice to Comply for unpaid license fees or unfilled tax returns to the business. Sometimes in order to satisfy their outstanding obligations with the City, businesses will pay the Inspectors directly, generally with checks. Or, more commonly, the Inspector will leave a self-addressed envelope with the business to mail in the payment. Notices to Comply sent through the mail include an envelope addressed to the Inspector handling the account.

**Issue, Impact, and Recommendation**

Proper separation-of-duties controls should be in place at all times for handling funds. Employees should not have complete control over a transaction from initialization to completion. Currently, Inspectors are receiving payment directly for the accounts they monitor. The potential exists for theft of payments because the Inspectors initiate the enforcement follow-up, track follow-up actions, receive any payments, and update the customer account. The potential also exists for Inspectors to accept bribes in exchange for canceling obligations on the licensing system or adjusting the amount owed. (See further discussion of this issue at **Conclusion 7**, page 19.) It is likely management would not detect a theft of funds, since they do not actively supervise each account follow-up effort.

It should be noted that Enforcement used to direct all mailed-in payments to an administrative employee, who would log in the payment, send the payment to the Treasury Division for processing, and then forward the related paperwork to the appropriate Inspector. This practice was discontinued when the Enforcement group had a reduction-in-force. Payments are no longer directed by Enforcement to Treasury for processing, but are received in Enforcement with the accompanying paperwork so accounts can be updated. We recommend that Enforcement return to their former practice of directing all incoming payments through one employee who does not have responsibility for monitoring any accounts.

**ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**  
Revenue and Consumer Affairs will ensure a procedure with proper separation-of-duties controls is put in place for receipt of tax investigation payments by June 30, 2005.

**Subfinding 2: Separation-of-duties controls are not adequate for handling NSF check payments for tax and license fees.**

Background

Occasionally businesses pay for City license fees and taxes with an NSF (non-sufficient funds) check. The bank returns these NSF checks to the Treasury Division. At the time we performed our audit fieldwork, Treasury was forwarding these checks to an Administrative Assistant in Enforcement, who worked with the business to obtain a replacement payment. Replacement checks were subsequently sent to the Administrative Assistant to be logged in, and were supposed to be passed to Treasury for processing and deposit.

Issue, Impact, and Recommendation

Proper separation-of-duties controls should be in place at all times for handling funds. There should be adequate physical controls over assets and records, and employees should not have complete control over a transaction from initialization to completion.

A former Enforcement administrative employee took advantage of a control weakness in the group's NSF procedures by stealing three replacement checks totaling \$300. The employee contacted the businesses for replacement checks and received the checks directly. A second party was not involved in reconciling or checking this work. Management became aware of the theft after Enforcement contacted one of the businesses because their account status was delinquent; the business then demonstrated that they had already paid. Consequently, the administrative employee was terminated. We recommend a new and properly controlled procedure for handling NSF checks be implemented. We also recommend that management consider adding credit checks to the background process for positions involving funds handling

**ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

Revenue and Consumer Affairs worked with the Treasury group and implemented a new procedure for handling NSF check payments. The new procedure includes proper separation of duties controls. Revenue and Consumer Affairs management has also proposed extending the City's Background Check policy to include all of the positions within the Department of Executive Administration dealing with cash handling or having fiduciary responsibilities.

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**Conclusion 7: Management Review of Obligation Adjustments, Obligation Cancellations, and Account Closures Is Not Adequate.**

Background

Business account information is maintained on the SLIM database system. All employees in the Revenue and Consumer Affairs areas of Tax Audit, Enforcement, and Operations have access to SLIM and can the ability to update customer accounts. SLIM access rights are based on job responsibilities, but all employees can adjust the dollar value of obligations (i.e., amounts due to the City), waive or cancel obligations, and close accounts. Accounts can be closed as either

Closed – Open Obligations, Closed – Uncollectible, or Closed – No Obligations. Closing an account as Uncollectible or with Open Obligations essentially stops the enforcement process.

#### Issue, Impact, and Recommendation

System access rights should be limited to the principle of “least privilege” for internal control purposes. There should be the appropriate level of management oversight for adjustments made to obligations, cancellation of obligations, and accounts closed with open obligations or as uncollectible. Currently, all employees with access to SLIM can perform these types of transactions and there is no systematic management review method of these types of transactions. Consequently, the potential exists for an employee to reduce or waive financial obligations either as a personal favor for a business or in return for something of value. Revenue and Consumer Affairs management reviews accounts on a non-systematic basis as they happen to be working with a given account.

Revenue and Consumer Affairs employees have legitimate reasons for being able to update obligations and close accounts. However, we recommend management consider implementing the following control procedures: 1) SLIM could be altered to require management approval for obligation adjustments, cancellations, and account closures that meet a certain dollar value parameter. 2) Management could periodically review exception type activity (i.e., adjustments, cancellations, and closures) for certain employees. This type of review could be done at the summary level and compare employees within the same job positions. Management probably has an idea of how much exception type activity would be reasonable, given the employee’s projects and responsibilities. Management could also consider limiting the ability to perform exception type transactions to only a few employees within each group, though this might require a major change to SLIM.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs will ensure a procedure is put in place to periodically review exception-type transactions by September 30, 2005.

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#### **Conclusion 8: The Enforcement Group’s Criminal Complaint Practices and Policies Need Some Improvement.**

##### Background

If a business is non-compliant with City licensing and tax requirements, the Enforcement group will contact them by mail, phone, or make on-site visits to try to bring them into compliance. If repeated efforts fail to motivate the business to become compliant, then the City may pursue legal action in the form of filing a criminal complaint. The City takes legal action only as a measure of “last resort.” If the Enforcement group decides to pursue legal action, they prepare the required case documentation for the Public and Community Safety Division of the City Attorney’s Office, who will prepare and file a criminal complaint if they determine that the case meets their filing standards. If a criminal complaint is filed, the business is notified and an intake hearing is scheduled with the Seattle Municipal Court. At this time, the business may sign a dispositional continuance and settle with the City, or it may choose to settle at a later hearing

called a pretrial. The terms of settlement include filing all past due returns and paying all past due payments and penalties within a relatively short time, and filing all ongoing returns and paying all ongoing taxes and penalties when due. If the business refuses to settle and comply with City requirements, the case will be set for trial. The City also has the option of filing a civil complaint against a non-compliant business. Although the penalties and fees associated with this type of legal action differ from a criminal complaint, the process is similar.

#### Issue, Impact, and Recommendation

There should be guidelines governing the Enforcement group's process for determining whether to pursue legal action against a non-compliant business and these guidelines should generally be followed. The guidelines should require consideration of the potential costs and benefits to the City for pursuing legal action. The policies and procedures for taking legal actions should be clear and reasonable to help ensure they are followed.

Currently, Enforcement is inconsistent in its pursuit of legal actions, and the Enforcement Inspectors believe the legal process is time-consuming and onerous. It appears that some Inspectors choose to request the City Attorney's Office file criminal complaints and some choose not to, based more on personal preference than the actual "facts and figures" of the case. Though Revenue and Consumer Affairs management reviews and approves all requests to file criminal complaints before they are sent to the City Attorney's Office, there are no established guidelines governing Enforcement's decision whether to pursue legal actions. It should be noted that the professional judgment of the inspector should always be an important factor in this decision process. (See historical data on Enforcement legal actions filed and pursued at **Appendix 3**.)

Gathering the necessary evidence to forward requests to the City Attorney's Office to file criminal complaints is a time-consuming, burdensome process for the Inspectors. They have to gather a lot of information about the business and business owner, some of which is difficult to obtain, and carefully document the case. The process can take three months from start to finish, and up to a day of the Inspector's time. The time involved may discourage some Inspectors from pursuing filing criminal complaints. In the past, Inspectors were authorized to issue a citation, which was a quick and easy process, so Inspectors used it frequently. This practice was discontinued by the City Attorney's Office for legal reasons. It should be noted that the City Attorney's Office is currently working with the Enforcement group and the Seattle Municipal Court to streamline the civil complaint procedures.

The current situation may result in the City not pursuing legal action against a non-compliant business when it would be in the City's best interests to do so. We recommend the City Attorney's Office assist the Revenue and Consumer Affairs Enforcement group in developing guidelines for determining whether legal action against a non-compliant business. These should be guidelines only, and decisions should always be made after considering the potential costs and benefits to the City. Once guidelines are in place, Revenue and Consumer Affairs management should monitor to ensure the guidelines are followed. We also recommend that the City Attorney's Office continue to work with the Enforcement group to streamline the legal action procedures, where possible.

## **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The City Attorney's Office and Revenue and Consumer Affairs have agreed to a procedure. Revenue and Consumer Affairs will pursue legal action when situations meet approved guidelines. Revenue and Consumer Affairs management will oversee this and ensure Enforcement inspectors follow these practices.

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### **Conclusion 9: Tax Refunds Are Not Always Issued in a Timely Manner.**

#### **Background**

Tax refunds can occur for several reasons. One is that taxpayers sometimes remit returns with inaccurate calculations resulting in overpayment of taxes. This is generally noted during the "tax detailing" process when the Operations group within Revenue and Consumer Affairs enters the financial information reported into the SLIM system, which recalculates the taxes owed. Or, the business could simply overpay, even though their calculations were accurate, thereby creating a credit balance on their account. Or, the business could send in an amended tax return for a prior period, indicating that they are due a refund. An Assistant Tax Auditor researches amended returns requesting refunds of over \$500 before they are approved. If a refund is due for any of these reasons, the return is sent to the Manager of Revenue and Consumer Affairs for review and approval. The business will then be sent some refund-related paperwork, and the actual refund check is sent out after the paperwork is satisfactorily completed and returned.

#### **Issue, Impact, and Recommendation**

Tax refunds should be issued in a timely manner to provide good customer service and to comply with Washington State Auditor's Office requirements. During audit fieldwork, we found there was a large backlog of accounts indicating a refund due, many dating back two quarters prior (or about 6 months old). This situation was due to a major backlog in the tax detailing function. (See details on this issue discussed at **Conclusion 12**, page 25.) The current practice of Revenue and Consumer Affairs is to issue a tax refund only after all tax returns from prior periods have been detailed to ensure the taxpayer did not underpay for a prior period. This situation results in poor customer service for business taxpayers. It also causes the City to be out of compliance with a State Auditor requirement that tax refunds be issued "timely." Resolving this issue hinges upon resolving the tax detailing backlogs. Alternatively, management could decide to issue refunds without waiting to get all tax returns from prior periods detailed first. However, this would only address tax refunds arising from amended returns and credit-balance accounts (caused by over-payments), not those arising from incorrect calculations or overpayments.

## **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Director of Revenue and Consumer Affairs will ensure operational procedures are revised to expedite the tax refund process by September 30, 2005.

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## **Conclusion 10: The City's Tradeshow Licensing Requirements Need Improvement.**

### **Background**

Chapter 6.20 of the Seattle Municipal Code covers the licensing requirements for tradeshow organizers and participating vendors for events that last 14 days or less and involve 25 or more vendors. The tradeshow event organizer is responsible for getting a tradeshow license at a cost of \$5 per participant per day, except for government participants (e.g., the U.S. Army), who are exempt. If the tradeshow will last more than 14 days or if the event involves fewer than 25 vendors, then each participant needs a City of Seattle business license. The City has one Inspector in the Enforcement group assigned to tradeshow events.

### **Issue, Impact, and Recommendation**

The Seattle Municipal Code should clearly state the licensing and taxation requirements for tradeshow organizers and participants, and these requirements should facilitate effective City enforcement efforts. Currently, the Code would benefit from the following improvements:

- Section 6.20.040B is deficient in its coverage of events hosted by non-profit organizations (e.g., schools) where some participants may be donating their proceeds to the host while some may be for-profit type vendors who are retaining their proceeds.
- Section 6.20.030A requires that tradeshow organizer apply for a tradeshow license at least one day before the event. The application includes a listing of all participants with business addresses, phone numbers, etc. If this information is mailed only one day before the event, this does not allow the City sufficient time to review it in advance, and perform any research or take any enforcement actions that might be needed. The Tradeshow Inspector recommended changing this requirement to a week before the event.

These current provisions hinder the City's ability to enforce the business licensing and tax code and ensure the proper amount is received in fees and taxes. We recommend that the Code be clarified on the two points listed above.

### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

The Revenue and Consumer Affairs division and the City Attorney's Office are currently working on revising Title 6 of the Seattle Municipal Code, and will address these issues as part of that effort. This should be complete by December 31, 2005.

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## **Conclusion 11: Communication of Business Licensing and Taxation Requirements to Construction Companies Could Be Improved.**

### **Background**

The City requires construction companies, contractors, and sub-contractors conducting work in the Seattle to comply with City business licensing and taxation requirements. Enforcement has one Inspector assigned to monitor all construction industry activities related to business licenses and taxes.

### Issue, Impact, and Recommendation

The City should make all reasonable efforts to communicate Seattle's business licensing and taxation requirements to construction companies, contractors, and sub-contractors. This is especially important because many of these companies are located outside of Seattle and perform work in the City occasionally, and may not know that they need to comply with these requirements. Currently, the website for the Department of Planning and Development does not reference the City's business licensing and tax requirements, though this department is responsible for issuing construction permits. The Department of Planning and Development provides information on business licensing and taxation at their permit counters, and also by displaying the Revenue and Consumer Affairs informational brochures in this area. Communication of requirements could be improved by including information regarding City business licenses and taxes to the Department of Planning and Development website.

### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

Revenue and Consumer Affairs is currently working with the Department of Finance to address this issue and to get a field for 'Business License' added to the building permit application. This should be completed by September 30, 2005.

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## **OPERATIONS, TRANSACTION PROCESSING, AND PAYMENT PROCESSING FUNCTIONS**

The Operations group within the Revenue and Consumer Affairs Division of the Department of Executive Administration and the Remittance Processing group within the Treasury Division perform most of the functions associated with transaction and payment processing for business licenses and taxes. This involves processing all incoming tax returns and license applications and renewals, processing, depositing, and recording all associated payments, and ensuring that the individual business accounts in the SLIM database are updated accurately and timely. The Operations group has the primary responsibility for Revenue and Consumer Affairs' document storage and retention. They are also the primary provider of customer service for the businesses via in-person assistance, telephone, and email.

Overall, we found internal controls to be adequate for the City's business tax and licensing operations, transaction processing, and payment processing functions. The City is doing a good job overall in communicating business taxation and licensing requirements, providing customer service, processing license applications and renewals, processing and depositing tax and license payments in a timely manner, performing regular information systems backups, and adhering to proper document storage and retention practices. However, we noted the following controls that could be improved: addressing large backlogs in processing tax returns, specifically for the "tax detailing" step of this process; improving the protection of checks during mail sorting; improving efficiency in tax return processing; and cleaning up the SLIM database to include accurate and up-dated information..

## **Conclusion 12: There Are Often Large Backlogs in Processing Tax Returns, Specifically for the Tax Detailing Function, Due to Current Resource Levels and Procedures.**

### **Background**

The Operations group supports business licensing and tax enforcement efforts by performing transaction processing functions and other miscellaneous but important tasks such as researching returned mail. One of the functions Operations performs is tax detailing, which involves entering tax return information into a tax-detailing module of the SLIM business licensing system. Then, SLIM recalculates the taxes due, compares this to what was remitted, and determines whether the taxpayer owes more money or a refund is due. Operations is the primary group responsible for ensuring the business accounts in the SLIM database are accurate and current.

### **Issues, Impacts, and Recommendations**

To ensure account information is current and accurate, transaction processing and other administrative tasks should be performed in a timely manner. Presently, this is not the case within the City. Details are discussed below:

- **Tax Detailing Backlogs:** During audit fieldwork, we noted tax-detailing backlogs of up to four months from the time the taxpayer had remitted a tax return. Consequently, tax returns for subsequent quarters were remitted by taxpayers before the returns from one or even two quarters prior had been detailed. It should be noted that the payments accompanying the tax returns were processed and deposited in a timely manner, but since the tax returns had not been detailed at the time of deposit, the City would not know if the taxpayer should owe more money or be due a refund. (See further discussion of the issue regarding tax refund timeliness at **Conclusion 9**, page 22.) In addition, this situation causes the SLIM account information to be out-of-date and inaccurate. Accurate account information is critical to help Enforcement determine which delinquent accounts should be pursued and it may also be important to help Tax Audit make audit selection decisions. Revenue and Consumer Affairs management indicated these backlogs occur every year during peak season (1<sup>st</sup> quarter), but they have been getting worse. We noted that large tax detailing backlogs were still present even late in the 3<sup>rd</sup> quarter of 2004. This situation appears to be caused by insufficient resources in the Operations area, exacerbated by several employee medical leaves. The efficiency of the current tax detailing procedures are also a significant factor and this issue is discussed in detail at **Conclusion 14**, page 26.
- **Returned Mail:** Revenue and Consumer Affairs receives a lot of returned mail in the form of license renewal forms, tax returns, notices the Inspectors have mailed out, etc. It is important to research this returned mail in a timely manner to determine whether the business has closed, re-located, or the information in the database is incorrect. The Operations group used to perform this function, but had to transfer the responsibility to Enforcement due to a lack of resources and the large tax detailing backlogs. During audit fieldwork, we noted large backlogs of returned mail to be processed. This is a low-priority activity for the Enforcement Inspectors because they try to focus on pursuing delinquent accounts and discovering unlicensed businesses since these activities have a greater potential to significantly affect City revenues.

Management may wish to consider adding additional resources to the Operations group, or at least to hire temporary help during the peak times of the year. The efforts of Operations support the City's business licensing and tax functions and help ensure that the Enforcement group can operate effectively, efficiently, and maximize efforts to recover lost revenues.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

Revenue and Consumer Affairs has hired additional temporary help (1.5 FTE's) to assist with the tax-detailing backlog and expects the backlog to be resolved by December 30, 2005.

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### **Conclusion 13: The Protection Of Check Payments Could Be Improved During The Mail Sorting Process.**

#### **Background**

The Operations group in the Revenue and Consumer Affairs Division sorts incoming business tax and license mail, and then passes it to the Remittance Processing group in the Treasury Division for document scanning and payment processing. Treasury used to perform the mail sorting function but transferred it to Operations after Treasury suffered resource cuts. During peak periods of incoming mail, there are times when Operations is unable to sort all of the mail received during a day. In these instances, they lock the mail, along with the associated checks, in a nearby storage room. The key to this storage room is kept hanging on a wall in a manager's office that does not have a door that locks.

#### **Issue, Impact, and Recommendation**

The City should take reasonable precautions to protect check payments from theft. The key to the Operations storage room is easily accessible to anyone walking by the manager's office, either during office hours or after hours. Many people have knowledge of the key, so while checks have not been stolen from the storage room in the past, there are opportunities for this to occur. We recommend securing any unsorted mail containing checks in such a manner that the fewest number of people have access to it as is operationally feasible.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

Revenue and Consumer Affairs will purchase a locking cabinet for storage of payment checks during the mail sorting process, as needed. The locking cabinet will be kept in the storage room and only Revenue and Consumer Affairs Operations personnel will have the key to this cabinet. This should be completed by June 30, 2005.

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### **Conclusion 14: Tax Return Processing Could Be More Efficient.**

#### **Background**

The Remittance Processing group in the Treasury Division scans tax returns and checks, deposits the checks, and records the payments to the business accounts in the SLIM database (via an automated data transfer process). The tax payment shows as a credit on the business account until the tax return is "detailed" and SLIM calculates the tax owed based on the financial

information reported by the business. The Revenue and Consumer Affairs Operations group handles tax detailing. As noted above at **Conclusion 12** on page 25, tax detailing involves manually entering the information off the tax returns into SLIM, and SLIM then determines whether the taxpayer owes more money or a refund is due. If late penalties are applicable, the system will include this in the calculation of what is owed.

#### Issue, Impact, and Recommendation

Tax return processing should be efficient and ensure tax returns are processed in a timely manner. Revenue and Consumer Affairs current procedures are not particularly efficient, primarily because the tax detailing process is highly manual. To perform tax detailing, an operator must scroll through several screens and enter the business account number, obligation number (that ties to a tax period), and every financial number the taxpayer has provided on the tax form. This is time-consuming and has contributed to the large backlogs discussed at **Conclusion 12**.

The State of Washington's Department of Revenue process, unlike the City's, is completely automated, and only designates exception type items for manual handling. The State scans the tax returns and the information on the returns is captured, checked for accuracy, and automatically uploaded to the business accounts. The City scans tax returns, as well, and so in theory could automate their tax detailing process. However, according to Revenue and Consumer Affairs management, the application the City uses to scan the returns (called WAUSAU) has limitations on how many fields of data it can capture. DEA management may want to consider either enhancing the WAUSAU system to allow for automated capture of tax return data or purchasing a new system. Another option suggested by the Manager of Operations is to enhance the SLIM Tax Detailing module by adding short-cuts such as using a scanner to read the bar-coded customer account number and obligation number, etc.

We recommend a cost-benefit analysis be performed to compare the cost of a system enhancement project or a new system against the benefit of labor cost savings generated by the elimination of manual tax detailing. It should also be noted that the City implemented on-line business tax filing capability during the 3<sup>rd</sup> quarter of 2004. Tax returns submitted on-line are automatically "detailed" and loaded to SLIM, without any manual intervention required. Revenue and Consumer Affairs management is hoping businesses will use this method of filing, which would in turn reduce the detailing volume.

#### **ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

On-line tax filing functionality has been implemented, so this will help reduce the volume of tax returns requiring tax detailing. Bar-code readers have been installed to read the business account number and this helps to reduce the manual effort of the tax detailing process. In addition, the Manager of Revenue and Consumer Affairs Operations is working with the Manager of the Treasury Division to explore options to automate the tax detailing process using existing computer scanning equipment. This would eliminate the need to manually detail the majority of the tax returns. Management estimates this project should be completed and implemented by December 30, 2005.

**Conclusion 15: The SLIM Database Account Information Needs To Be Cleaned Up To Reflect Accurate And Up-Dated Information.**

**Background**

Every business customer has an account on SLIM. If the customer has not filed a tax return, renewed their license, paid a penalty, or owes interest, this will show as a “delinquency” on their account. The Inspectors in the Enforcement group regularly review a report showing all of their delinquent accounts so they can follow-up with the businesses.

**Issue, Impact, and Recommendation**

Account information in SLIM should be accurate and up-to-date. Old obligations for a small dollar amount (e.g., a \$5 penalty from five years ago) should be cleaned off the system because it is not worth the Inspector’s effort to try to collect it. Currently, there are many accounts on SLIM that require clean up. There are many old obligations for small dollar amounts. There are also many \$0 interest amounts listed on accounts that were caused by a systems issue that lasted for two years. This situation has resulted in delinquency reporting including many accounts that are not really delinquent. This means that the Inspectors have to waste their valuable time sorting through the report to find the delinquent accounts worth reviewing.

**ACTIONS PLANNED BY THE DEPARTMENT OF EXECUTIVE ADMINISTRATION**

Clean up of the SLIM database is an ongoing process and is dependent on resources. Management did receive approval and is currently working on filling an additional full-time position for the Revenue and Consumer Affairs Operations group. This group expects to be caught up with tax return processing and able to focus on the database clean-up effort by 4<sup>th</sup> quarter, 2005.

**APPENDIX 1**  
**DEPARTMENTAL AND AGENCY RESPONSIBILITIES AND FUNCTIONS RELATED**  
**TO BUSINESS TAXES AND LICENSING RESPONSIBILITIES**

<b>City Department or Outside Agency</b>	<b>Responsibilities And Functions</b>
Revenue and Consumer Affairs (RCA) – Director’s Office	<ul style="list-style-type: none"> <li>• Advise on Tax and Licensing Code Content</li> </ul>
Revenue and Consumer Affairs - Operations	<ul style="list-style-type: none"> <li>• Communicate tax &amp; licensing requirements – Mail, Website</li> <li>• Production Mailings of License Renewals and Tax Returns</li> <li>• Customer Service – Phone, Email, In-Person</li> <li>• Process License Applications and Renewals – In-Person</li> <li>• “Detail” Tax Returns</li> <li>• Maintain Business Accounts in SLIM Database</li> <li>• Maintain Records – On-Site, Off-Site</li> </ul>
Treasury – Remittance Processing	<ul style="list-style-type: none"> <li>• Process License Applications, Renewals, Tax Returns, and Payments Received Through Mail</li> <li>• Post Payments to General Ledger/SUMMIT</li> <li>• Deposit Payments</li> </ul>
Revenue and Consumer Affairs - Enforcement	<ul style="list-style-type: none"> <li>• Discover Businesses Operating without a License</li> <li>• Identify and Follow Up With Non-Compliant or Delinquent Businesses</li> <li>• Pursue Enforcement Actions</li> <li>• Specialty Area Enforcement (Tradeshows, Admissions, Construction, Utilities, Gambling)</li> <li>• Review and Approve Tax Refunds</li> </ul>
Revenue and Consumer Affairs – Tax Audit	<ul style="list-style-type: none"> <li>• Conduct Tax Audits – Field &amp; Office</li> <li>• Issue Tax Assessments</li> <li>• Follow Up with Tax Assessments Owed and Process Payments</li> <li>• Track and Monitor Tax Assessment Time-Pays</li> <li>• Handle Tax Appeals</li> </ul>
City Attorney’s Office	<ul style="list-style-type: none"> <li>• Advise RCA on Civil and Criminal Law Matters</li> <li>• Represent City in Civil and Criminal Cases</li> </ul>
Seattle Municipal Court	<ul style="list-style-type: none"> <li>• Hear Business Cases Challenging Enforcement Actions</li> </ul>
Hearing Examiner	<ul style="list-style-type: none"> <li>• Hear Tax Appeal Cases</li> </ul>
Department of Executive Administration Business Technology - Applications	<ul style="list-style-type: none"> <li>• Applications Development and Testing of System Enhancements and Changes</li> <li>• Database Administration</li> <li>• Local Network Backups</li> </ul>
Treasury – Systems	<ul style="list-style-type: none"> <li>• Serve as Systems Administrator for SLIM and Treasury Systems</li> <li>• Change System Access Rights</li> <li>• Review, Test, and Approve System Changes</li> </ul>
Department of Information Technology – Distributed Personal Computing Services and Data Center	<ul style="list-style-type: none"> <li>• Central Database Backups</li> </ul>
Model Tax Ordinance Group	<ul style="list-style-type: none"> <li>• Establish Tax Policy</li> </ul>

## APPENDIX 2

### TAX AUDIT AND ENFORCEMENT REVENUE RECOVERY DATA FOR 1999 THROUGH 2004<sup>9</sup>

<b>Years</b>	<b>Tax Audit Recoveries</b>	<b>Enforcement Recoveries</b>	<b>Totals</b>
<b>1999</b>	\$4,988,583	\$ 3,087,442	\$ 8,076,025
<b>2000</b>	\$6,101,617	\$3,320,588	\$9,422,205
<b>2001</b>	\$5,398,928	\$3,548,364	\$8,947,292
<b>2002</b>	\$6,756,423	\$4,080,081	\$10,836,504
<b>2003</b>	\$16,343,692	\$3,086,230	\$19,429,922
<b>2004</b>	\$7,496,836	\$3,298,751	\$10,795,587

## APPENDIX 3

### LEGAL ACTIONS AGAINST NON-COMPLIANT BUSINESSES For Business Licensing and Tax Issues - 1994 through 2003 <sup>10</sup>

<b>Year</b>	<b>Reports Made By RCA Enforcement</b>	<b>Number of Cases Actually Filed</b>
<b>1994</b>	179	187
<b>1995</b>	96	103
<b>1996</b>	258	256
<b>1997</b>	98	109
<b>1998</b>	177	203
<b>1999</b>	122	179
<b>2000</b>	236	304
<b>2001</b>	61	64
<b>2002</b>	4	3
<b>2003</b>	22	75
<b>Total</b>	1253	1483

Note: The cases filed sometimes exceeds the number of reports because multiple counts of the same charge can be filed.

<sup>9</sup> Data provided by the Director of Revenue and Consumer Affairs.

<sup>10</sup> Data provided by the City Attorney's Office.



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## Office of City Auditor's Report Evaluation Form

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Our mission at the Office of City Auditor is to help assist the City in achieving honest, efficient management and full accountability throughout the City government. We service the public interest by providing the Mayor, the City Council and City managers with accurate information, unbiased analysis, and objective recommendations on how best to use public resources in support of the well-being of the citizens of Seattle.

Your feedback helps us do a better job. If you could please take a few minutes to fill out the following information for us, it will help us assess and improve our work.

\* \* \* \* \*

Report: Business Taxes and Licensing  
Release Date: May 18, 2005

Please rate the following elements of this report by checking the appropriate box:

	<b>Too Little</b>	<b>Just Right</b>	<b>Too Much</b>
Background Information			
Details			
Length of Report			
Clarity of Writing			
Potential Impact			

Suggestions for our report format: \_\_\_\_\_

\_\_\_\_\_

Suggestions for future studies: \_\_\_\_\_

\_\_\_\_\_

Other comments, thoughts, ideas: \_\_\_\_\_

\_\_\_\_\_

Name (Optional): \_\_\_\_\_

Thanks for taking the time to help us.

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Call: Susan Cohen, City Auditor, 206-233-3801

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